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No. 85-242

In the Supreme Court of the United States

OCTOBER TERM, 1985

WEST CENTRAL COOPERATIVE, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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Petitioner challenges the court of appeals' holding that it did not qualify as a tax-exempt farmers' cooperative during its 1974 fiscal year because it failed to satisfy the statutory requirement that substantially all of its stock be owned by producers who marketed their products through or purchased their supplies from it.

1. Petitioner is a capital stock marketing and purchasing farmers' cooperative. It purchases grain from its members and sells the grain to buyers on the open market. It also purchases farm supplies and equipment for resale to its members. In addition, petitioner owns and operates grain storage facilities as a federally licensed warehouse. Pet. App. 54-55.

Petitioner's members each receive one share of stock. Members earn patronage dividends based on the quantity of goods that they sell through or purchase from petitioner

in a given year (Pet. App. 55). According to petitioner's records, 83.75% of its stock was owned during its 1974 fiscal year by members who marketed products through or purchased supplies from it, and those shareholders were the only ones who were eligible to receive patronage dividends (*id.* at 56). Patronage dividends were not paid to members who transacted no business with petitioner during 1974 but merely stored their grain in petitioner's warehouse (see *id.* at 55-56).

Section 521 of the Internal Revenue Code[1] provides a tax exemption for certain farmers' cooperatives. A cooperative association having capital stock can qualify for this exemption only if "substantially all such stock * * * is owned by producers who market their products or purchase their supplies and equipment through the association" (I.R.C. § 521(b)(2)). The Commissioner for many years has interpreted the words "substantially all" as used in Section 521(b)(2) to mean 85% or more. *E.g.*, Rev. Rul. 73-248, 1973-1 C.B. 295.

Petitioner was first recognized as an exempt farmers' cooperative in 1958. Upon audit of petitioner's 1974 tax year, however, the Commissioner determined that it no longer qualified for exemption because only 83.75% of its stock was owned by producers who had marketed their products or purchased their supplies from it during that period. The Commissioner accordingly withdrew petitioner's exemption and asserted a tax deficiency in the amount of $57,000. Pet. App. 56-57.

Petitioner paid the asserted deficiency and, following the denial of its administrative claim for refund, brought this refund suit in the United States District Court for the

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[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the tax year at issue (the Code or I.R.C.).

Northern District of Iowa. The district court sustained the Commissioner's position (Pet. App. 63-72) and the Eighth Circuit affirmed in a per curiam decision. It held that the Commissioner's interpretation of "substantially all" to mean 85% or more was "reasonable" and "in keeping with the congressional mandate" (*id.* at 58). And it noted that, according to petitioner's own records, only 83.75% of its stock was owned by qualifying members during its 1974 tax year. The court rejected petitioner's argument that stock owned by members who merely stored grain in its warehouse should be counted toward the 85% test, holding that "the language of [Section] 521(b)(2) is clear and storing grain with a cooperative is not marketing or purchasing through a cooperative" (Pet. App. 61).

2. While appearing to concede the validity of the 85% test (Pet. 37), petitioner principally contends (*id.* at 16-36) that the courts below erroneously failed to consider business that its members transacted with it in years other than 1974 in ascertaining whether it satisfied that requirement. The question for decision, however, was whether petitioner qualified for tax exemption during its 1974 tax year. It is well established that the federal income tax system is based on the principle of annual accounting. *Heiner* v. *Mellon*, 304 U.S. 271, 275 (1938); *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365-366 (1931). In what petitioner concedes (Pet. 21-22) to be the only other appellate decision precisely on point, the Eighth Circuit has previously held that, in determining whether the "substantially all" test of Section 521(b)(2) is satisfied, it is proper to consider only stock owned by members who market through or purchase from the cooperative "on a current basis." *Co-operative Grain & Supply Co.* v. *Commissioner*, 407 F.2d 1158, 1164 (8th Cir. 1969). On remand of that case, the Tax Court construed "on a current basis" to require "actual yearly participation" (32 T.C.M. (CCH) 795, 798 (1973)), and the Eighth Circuit

below approved that construction of its earlier decision (Pet. App. 59-60).

Because only 83.75% of petitioner's stock was owned by members who actually purchased or sold goods through it during 1974, the courts below correctly held, in accordance with the annual accounting principle, that "substantially all" of petitioner's stock was not owned by qualifying members and hence that it was not entitled to a tax exemption in 1974. Petitioner does not allege, nor is there, a conflict among the circuits on this question. Indeed, petitioner's argument boils down to a contention (see Pet. 19-22) that the panel below misinterpreted the Eighth Circuit's prior decision.

3. Petitioner alternatively contends (Pet. 36-49) that, even if the courts below were correct in focusing exclusively on its members' activities in 1974, stock owned by members who merely stored grain in its warehouse should be counted in determining whether it passed the 85% test. Section 521(b)(2), however, provides in pertinent part that substantially all of the cooperative's stock must be owned by members "who market their products * * * through the association." As the court of appeals correctly held (Pet. App. 61), the mere act of storing grain, without more, does not amount to "marketing." Indeed, petitioner in implementing its patronage dividend policy itself acknowledged that storing grain does not amount to marketing, since farmers who merely stored grain with it were not eligible to receive patronage dividends (Pet. App. 55-56).

Petitioner's theory, moreover, if accepted, would defeat Congress's intention in enacting the statute. If mere storage of grain were considered "marketing" for purposes of Section 521(b)(2), the statute's "substantially all" requirement would be eviscerated, since any cooperative could ensure its qualification for tax-exempt status simply by having 85% of

its members perpetually store a minimal amount of grain in its warehouse. It would then make no difference whether *any* of its shareholders actually sold their products through or purchased their equipment and supplies from the cooperative (I.R.C. § 521(b)(2)). There are, of course, agricultural cooperatives that operate for the sole or principal purpose of storing their members' grain. See, *e.g.*, *Pomeroy Cooperative Grain Co.* v. *Commissioner*, 288 F.2d 326 (8th Cir. 1961). Such organizations, however, cannot qualify as "exempt farmers' cooperatives" under Section 521(b)(2), but are subject to a limited form of taxation as non-exempt cooperatives under Sections 1381-1383 of the Code, which prescribe the tax treatment of cooperatives generally.[2]

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[2]Contrary to petitioner's contention (Pet. 39-42), there is no authority for the proposition that the mere storage of grain at a cooperative, without more, constitutes the "market[ing of] products * * * through the association" within the meaning of Section 521(b)(2). Petitioner's reliance (Pet. 41) on *Pomeroy Cooperative Grain Co.* v. *Commissioner, supra*, is misplaced; that case involved a non-exempt cooperative, and thus no question concerning the construction of Section 521 was presented. As petitioner notes (Pet. 40, 41-42), numerous cases and revenue rulings have defined "marketing" as an aggregate of functions, including storage, involved in transferring title and moving goods from the producer to the customer. *E.g.*, *Treasure Valley Potato Bargaining Ass'n* v. *Ore-Ida Foods, Inc.*, 497 F.2d 203, 215 (9th Cir. 1974); Rev. Rul. 67-430, 1967-2 C.B. 220. These authorities, however, simply stand for the common-sense proposition that storage is a necessary adjunct of the sale of goods in which a marketing cooperative may permissibly engage; none holds or even suggests that the long-term storage of grain, without more, amounts to "marketing" for purposes of Section 521(b)(2).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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